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COST EFFECTIVENESS AND LEGAL COMPLIANCE: AN ANALYSIS OF SECURITIES LAW COMPLIANCE FOR THE START-UP COMPANY

Douglas A. Tanner*

Securities law, especially to the nonpractitioner, is a complex array of technical regulations. Companies attempting to comply with these regulations often face burdensome costs in relation to existing resources. This can be especially true for start-up companies which must apply their limited resources to building their business. For this reason, such companies may take short-cuts in securities law compliance. Such decisions made with good reason at the early stages of the company's growth can hinder, or even prevent, realization of long-term company goals.

This article first explores cost-effectiveness as applied to securities law compliance, exploring why the approach is valid in this context. Then, by analyzing the uncertainties and choices available in the application of exemptions from registration and qualification in small business offerings, the article shows that in many areas there are broad degrees of compliance. Subjective decisions involved in choosing a conservative or liberal approach to compliance encourage clients to consider the resources required to be expended to reach a given degree of compliance. The article focuses on the costs of an aggressive compliance approach (which may risk non-compliance),¹ highlighting particular areas in which cutting corners on compliance may disproportionately increase future costs. Such an evaluation may allow an intelligent cost/benefit approach to be taken. Although the article touches on some aspects of state securi-

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1. For the purposes of this article, "non-compliance" is used broadly to mean a decision not to take the most conservative and clearly correct legal course. It is not intended to imply that the chosen course is clearly violative of the securities laws. Non-compliance must be read in relation to the range of possible compliance outlined in this article.

ties compliance, only the specific provisions of federal law are employed in the analysis of these issues.

I. THE COST-EFFECTIVE CLIENT AND THE RISKS OF INCOMPLETE COMPLIANCE

Most practicing attorneys are familiar with the horrified look of disbelief that arises as the attorney summarizes to the client the burdens of securities law compliance for a proposed client transaction. Counsel who suggest a narrow, conservative approach to legal matters often encounter the surprising disrespect many entrepreneurs exhibit for a system so complex. Such insistence on technical and absolute compliance may not recognize the business context. In doing so, the attorney may lose sight of the role of legal counsel which is to provide sufficient legal information to the client so that the client can make an appropriate business decision. This role can be especially difficult for the attorney when compliance may be arguable in many instances.

Federal and state securities law issues arise in the formation and growth of every business. For a large number of securities transactions, federal law is ignored because of unfamiliarity or lack of information. A significant business financing, however, with investors other than relatives or sophisticated financial institutions, requires attention to compliance with applicable law. Compliance can be viewed as an absolute—a matter of black and white. In many areas, however, compliance more realistically depends upon a series of judgmental calls. The attorney who insists upon very conservative calls in all cases often mixes legal and business decisions. The entrepreneur usually weighs whether to comply meticulously, achieving a certainty of compliance, or to take a leaner approach that presents greater risk, but also a higher probability of achieving business goals. This approach clearly implies cost/benefit analysis: the decision to incur reasonable risk in order to achieve a desired goal. If a cost/benefit approach is legitimate in connection with securities compliance decisions, attorneys should direct legal advice to facilitating these decisions.

Can a cost/benefit approach be justified in the face of the direct statutory and regulatory requirements applicable to sales of securities? If a pure economic decision is appropriate, the client would evaluate the cost of a particular course of action in comparison with the individual benefit to be gained by such action. As an extreme, the free enterprise system operates on this principle, with the justice system internalizing social costs so that they are borne by the bene-

fitting individual. In the context of a securities transaction, the cost to a client consists of more than the mere monetary cost for professional and other assistance necessary to comply with the law. The client also faces an indirect cost—compliance may place restrictions on the client's actions which may cause the offering to fail. Legal compliance may delay the start of the sale of securities or require that an offering be restricted in a manner that assures failure.

Compliance also benefits the client by cost-avoidance which allows the client to avoid costs associated with failure to comply with securities laws. In addition, compliance may protect social standing and recognition that might be lost through non-compliance. In balancing these factors, a client should discount the cost of the non-compliance by the probability of non-compliance being discovered and established. From the perspective of the entrepreneur, this evaluation of costs and benefits is similar to that in any other business decision.

Of course, an attorney should not make a cost/benefit decision and ethically advise a client to violate the law.² If the client expresses an intent to violate express statutory requirements in an offering of securities, the attorney may wish to disassociate himself or herself from the transaction.³ However, in the securities area, the client may choose among a range of actions, none of which are illegal, but some of which may be on the borderline of compliance. The attorney therefore is often faced with difficult decisions. The more the attorney understands the issues and can advise the client of the true costs and risks, the better that attorney can serve his or her client. There may be a broad area in which an attorney would not be willing to opine that the law has been complied with, but where a colorable claim of compliance exists. In these areas, the client, properly advised, should be the person choosing the course of action.

Obviously, taking a cost/benefit approach to compliance raises

2. For example, pursuant to Rule 7-101 of the Rules of Professional Conduct of the State Bar of California, a member of the state bar cannot advise the violation of any law, rule or ruling of a tribunal unless he believes in good faith that such law, rule or ruling is invalid. CAL. RULES PROF. CONDUCT Rule 7-101 (West 1984).

3. Rule 1.16(b)(1) of the American Bar Association Model Rules of Professional Conduct allows a lawyer to withdraw from representation of a client if the client persists in a course of conduct the lawyer reasonably believes to be criminal or fraudulent. A lawyer is not required by Rule 1.16 to withdraw unless the lawyer's actions are furthering a violation of law or violate the rules of professional conduct. In addition, it is possible that continued involvement by the attorney in an offering which is found to be fraudulent may result in personal liability on the part of counsel. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.16 (1983).

risks not present in most business decisions. The securities laws include both civil and criminal provisions. Non-compliance may have much higher costs than in other business decisions. Businessmen are not in business to violate established rules. But as the securities laws have no absolute standards in many instances, costs can be evaluated in terms of a risk of non-compliance. These risks can be divided into three general areas: (1) criminal liability; (2) liability for fraudulent acts; and (3) civil liability for failure to register an offering required to be registered. For the reasons to be discussed below, the third area has the most significant practical effect on the cost/benefit approach of most clients.

Both federal and state securities statutes provide criminal sanctions for knowing violators.⁴ The application of criminal sanctions would normally decide on its face the outcome of any cost/benefit trade-off. However, the rarity of prosecutions under these provisions and the egregious facts under which such prosecutions ordinarily occur significantly lessens the perceived cost of these sanctions. Given colorable compliance, criminal provisions would not normally weigh heavily as a cost to a person not contemplating fraud.⁵

Both federal and state laws also contain antifraud provisions which provide for civil damages to a purchaser for losses caused by material misstatements or omissions.⁶ These provisions have been held generally to require scienter, or some knowing or reckless element associated with the disclosures.⁷ Although these provisions

4. Under section 24 of the 1933 Act, any person who willfully offers or sells unregistered securities for which no exemption is available is subject to both a fine and imprisonment. 15 U.S.C. § 78f (1983). Similarly, sections 25540 and 25541 of the California Corporate Securities Law of 1968 [hereinafter cited as the California Law] provides up to one year imprisonment and up to \$10,000 in fines for one who willfully violates any provision of the California Law or who willfully employs or defrauds someone in connection with the offer, purchase or sale of a security. CAL. CORP. CODE §§ 25540, 25541 (West 1985).

5. Criminal sanctions establish the floor of compliance. Criminal provisions will prevent a person from absolutely ignoring the securities laws. However, given the uncertainties of application discussed *infra*, criminal sanctions do not weigh heavily in determining the extent of compliance.

6. Section 12(2) of the Securities Act of 1933, as amended, 15 U.S.C. § 781(2) ("the 1933 Act"), provides that a person who offers or sells a security in writing or orally, and includes an untrue statement of material fact or omits to state a material fact necessary to make the statements, in light of the circumstances in which they were made, not misleading without demonstrating that he did not know and in the exercise of reasonable care could not have known of the untruth or omission, is liable to the purchaser at law or equity for the consideration paid plus interest upon return of the security or for damages. *See also* section 17 of the 1933 Act, 15 U.S.C. § 78q (1983), § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(b) (1983) ("the 1934 Act"); and Rule 10b-5 of the Securities and Exchange Act 17 C.F.R. § 240.10b-5 (1985).

7. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

deter outright fraud, clients normally are not seeking to misstate facts. Disclosure provisions based upon misstatements or omissions normally do not necessitate large expenditures, and the costs are therefore not factored into a decision. Clients may not realistically assess these provisions as potential costs for two reasons: (1) with rare exceptions, clients do not intend to commit wrongs and believe strongly in their company's prospects, and (2) clients undoubtedly underestimate the creative hindsight of the securities litigation bar in discovering misstatements and omissions. Antifraud provisions are therefore sufficient to cause most clients to moderate written disclosures, but are not major cost concerns in most instances.

A more realistic and easily perceived cost to the client arises through the registration and qualification requirements. Under federal law, it is unlawful for any person, directly or indirectly, to use interstate commerce or the mails to offer to sell a security without an applicable exemption unless a registration statement has been filed with the Securities and Exchange Commission ("SEC") under the Securities Act of 1933 ("the 1933 Act").⁸ Similarly, under most state laws, an offer or sale must be qualified unless an exemption is available.⁹ A person purchasing in an offering in violation of these provisions has the option of suing the issuer or any person involved in the offer or sale for rescission or for damages. Thus, sales in violation are merely sales of "puts," and, independently of intent or the quality of disclosure, the issuer and its principals become guarantors of the venture's success. This prospective invasion of the founder's personal net worth, independent of the quality of disclosure or knowledge of risk of the buyer, is usually sufficient incentive to assure cooperation with counsel. If a rescission right were a certainty in a given course of action, few issuers would choose to proceed.

But the existence or not of an exemption is not usually clear cut. Often the course of action that will assure the availability of an exemption will decrease the probability of successfully raising the desired funds. Unless a different course can be suggested that both provides a reasonable possibility of success and clearly removes the possibility of loss of an exemption, the client may wish to proceed with the initial course and assume a level of risk that an exemption would be lost and that compliance may not be adequate. This third "cost" has the client's attention, but the ultimate question of

8. 15 U.S.C. § 77c (1983).

9. See, e.g., UNIF. STATE SECURITIES ACT § 301, 7b U.L.A. 550 (1985); CAL. CORP. CODE § 25110 (West Supp. 1985).

whether a cost/benefit approach is appropriate rests on whether a range of compliance in securities offerings of start-up companies is possible. The next section of this article explores this issue and describes the uncertainties in application of exemptions from federal registration in start-up financings.

II. CERTAINTY AND THE PRIVATE OFFERING EXEMPTION— THE ELUSIVE CONCEPT.

This article has proposed that the costs and benefits of compliance can be evaluated by persons involved in the offer and sale of securities. However, the approach would have little application in a world of certainty. For example, one could assume a world in which federal qualification was required for each sale of securities. Absent criminal sanctions, failure to qualify a known security would be a decision to become a guarantor of the investment. With criminal sanctions, failure to qualify would evidence a perhaps foolhardy belief that the seller would not be caught. In both cases, there remain cost/benefit decisions, but of much more limited rationality and scope.

As a practical matter, the world of securities law is not one of absolutes. The creation of exemptions from an absolute qualification requirement reflects the admission by legislators and administrators that the benefit of compliance can appropriately be weighed against the cost to society of non-compliance.¹⁰ If uncertainties are present in the exemptions themselves, free choice of a range of cost-effective steps increasing or decreasing the risk of being in non-compliance becomes available. Risk is no longer "on" or "off", but a matter of degree corresponding to a range of compliance costs. This section outlines the reasons that uncertainties in the application of exemptions to securities qualification and registration available to start-up businesses encourage a cost/benefit approach to compliance. To understand the reasons which often make compliance a matter of judgment, this article first outlines the application of federal registration exemptions, focusing on those areas in which counsel can at best provide guidelines for compliance.

For a start-up or early-stage business, federal registration is prohibitively expensive. Over the past 15 years, the exemptions

10. It should be noted that this societal cost/benefit balance is a different one than that which the individual contemplating a compliance decision faces. The costs to society are broader than the individual costs and the benefits are both economic and social. The sanctions inherent in a regulatory pattern help internalize these social costs and benefits of the individual decision.

from federal registration available to small business in the sale of securities have been clarified. Prior to 1974, persons interested in raising capital for a new or young business had two primary sources of exemption. The first was section 3(a)(11) of the 1933 Act,¹¹ which exempts from registration any security which is part of an issue offered and sold only to persons residing within a single state or territory, where the issuer of such security is a person resident and doing business within, or if a corporation, incorporated and doing business within such state or territory. The second was the so-called private offering exemption provided by section 4(2) of the 1933 Act,¹² which exempts transactions not involving a public offering. Although substantial judicial gloss has been added between 1933 and the present, as will be discussed below, the application of these statutory provisions has not led to certainty in application.

Section 3(a)(11). Section 3(a)(11) provides a transactional exemption which permits intrastate, local financing of businesses both organized and operating in a single state. For such transactions, Congress was of the view that state law was adequate to protect investors. As with section 4(2) of the 1933 Act, the exemption does not relieve an issuer from civil and criminal sanctions for false, misleading, or fraudulent statements and practices. Many commentators have pointed out the difficult questions created by the language of section 3(a)(11).¹³

If a start-up company can take advantage of section 3(a)(11), it reaps the advantages not available to private offerings of being allowed general advertising, no limitations on the number of purchasers and no investor sophistication requirements. Reliance on section 3(a)(11) is recognized by most counsel as being risky, however, because the exemption can be easily lost for the entire offering through inadvertence. For example, no definite standards exist under section 3(a)(11) for determining an investor's place of residence, whether the issuer is doing business within the state, or whether and for how long the securities must remain in the state. The SEC has long taken the position that a single offer outside the state, without any such sales, will cause the exemption to be lost for the balance of an issue sold entirely within the state.¹⁴ An unintention-

11. 15 U.S.C. § 77c(a)(11) (1983).

12. 15 U.S.C. § 77d(2) (1983).

13. See, e.g., Hicks, *Interstate Offerings Under Rule 147*, 72 MICH. L. REV. 463 (1974); Long, *A Lawyer's Guide to the Intrastate Exception and Rule 147*, 24 DRAKE L. REV. 471 (1975).

14. See *Ned J. Bowman Co.*, 39 S.E.C. 879 (1960); *Hillsborough Inv. Co. v. SEC*, 276 F.2d 665 (1st Cir. 1960).

tional offer to a person who turns out to be a resident of another state may, therefore, remove the availability of the exemption. For these reasons, the intrastate offering exemption is not an exemption of first choice. However, the flexibility provided by such offerings may allow certain businesses which rely on the intrastate exemption to be funded that could not otherwise be funded through dependence on other exemptions or safe harbors. An understanding of the value of this exemption will assist the client in determining if the risk of non-compliance is justified.

Section 4(2). Section 4(2) of the 1933 Act provides the federal exemption most often relied upon by start-up issuers. The exemption has been interpreted as being available for securities offerings to sophisticated offerees and purchasers who have access to the same kinds of information that a registration under the 1933 Act would provide and are able to fend for themselves as knowledgeable investors, and where the offering is not conducted in a public manner.¹⁵ Case law over the last 50 years is full of very strong language restricting availability of the section 4(2) exemption.¹⁶ As a result, the exemption ordinarily is viewed in a restrictive light with substantial uncertainty of application.

Unfortunately, a great deal of the strong language in these cases is dicta. Often the facts presented in a given case assure a finding of liability without reference to one or more of the tests enunciated. However, at least one commentator has distilled the statutory law of private placements under section 4(2) to five general requirements:

- (1) that the offerees met qualification standards;
- (2) that the manner of offering was appropriate;
- (3) that appropriate information was made available to offerees;
- (4) some limitation on the number of offerees and purchasers;
- and
- (5) the absence of redistribution.¹⁷

A range of factual considerations and experience is involved in eval-

15. *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953); *SEC v. Continental Tobacco Co.*, 463 F.2d 137 (5th Cir. 1972).

16. *See, e.g., SEC v. Continental Tobacco Co.*, 463 F.2d 137 (5th Cir. 1972); *Hill York Corp. v. American International Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971); *Lively v. Hirschfeld*, 440 F.2d 631 (10th Cir. 1971); *United States v. Custer Channel Wing Corp.*, 376 F.2d 675 (4th Cir. 1967), *cert. denied*, 389 U.S. 850 (1967). Despite the strong language in such cases, often the holdings turn in fact on procedural issues such as the failure of defendants to introduce sufficient evidence to carry the burden of proof that an exemption was available. *Id.*

17. *Schneider, The Statutory Law of Private Placements*, 14 REV. OF SECURITIES REGULATIONS 869 (1981).

uating the application of these factors to a particular offering of securities.

Absent a definitive court decision on the particular facts, however, there is no absolutely correct answer to whether the exemption is available in a particular case. It is clear that the larger the group of offerees and purchasers, the less sophisticated such persons are, the less control the issuer exerts in monitoring their qualifications, the fewer pre-existing contacts to the founders and the issuer and the less information disclosed or to which investors have access, the greater the risk that the issuer will not be able to sustain the burden of proof that the section 4(2) exemption is available. The "feel" to a non-public offering may be lost by the start-up company by inattention to any one of the above factors. If compliance is strict in all but one area, an issuer may have more flexibility in the degree of compliance in the last area.

Offeree qualification does not appear to be a strict requirement. The SEC has itself recognized:

Clearly, in an offering relying exclusively on section 4(2) for an exemption from registration, all offerees who purchase must possess the requisite level of sophistication. The sophistication of each of those to whom the securities are offered who do not purchase is not a fact that in and of itself should determine mechanically the availability of the exemption; the number and the nature of the offerees, however, are relevant in determining whether an issuer has engaged in a general solicitation or general advertising that would preclude reliance on the exemption of section 4(2).¹⁸

If an issuer uses common sense in identifying offerees, provides information or access to information to all purchasers, and restricts purchasers to a number that is small if dealing with less sophisticated investors and somewhat larger if dealing only with sophisticated investors, this author believes section 4(2) will generally be available.

Even if this conclusion is accepted, the ultimate decision as to whether "generally will be available" is sufficient protection to the client depends upon the risk aversity and ultimate goals of the client. This may place the attorney in an awkward position if the attorney believes that the client is making a decision against the client's best interests. However, the attorney best serves the client by clearly outlining all the pros and cons of a given course of action.

18. SEC Release No. 33-6455 (Mar. 3, 1983), 27 SEC DOCKET 347, 362, Question and Answer No. 73.

If the client never intends to raise additional funds and intends always to be very closely held, even an extreme degree of risk may be acceptable. On the other hand, if a future public offering is a certainty, good business judgment would dictate that additional compliance cost, providing the funds are available, would be well-placed both to reduce any issues in the registration and to present the best "face" to the investing public down the line.

As has been discussed, both sections 3(a)(11) and 4(2) of the 1933 Act are full of uncertainties that create risk of liability because appropriate compliance is not always clear-cut. At the same time, these uncertainties provide a broad range of chosen compliance that will reduce or increase the uncertainties involved. It is these uncertainties which encourage start-up companies with few resources or alternatives to choose a level of compliance expenditures that accords with their risk profile.

To reduce the uncertainties of the statutory exemptions the SEC has adopted rules providing safe harbors. These safe harbors have their own sometimes burdensome requirements and may not be helpful to all start-up businesses. As will be discussed below, uncertainties in application of the safe harbors themselves often encourage a cost/benefit trade-off. So long as this cost/benefit allows a supportable argument for compliance with the law, the attorney should be allowed to continue to represent and assist the client in choosing the manner to comply with the safe harbors. This would be true even if the attorney could suggest a more comprehensive approach.

The SEC adopted Rules 146 and 147¹⁹ in 1974 to provide greater objectivity and certainty in determining whether sections 4(2) and 3(a)(11) exemptions, respectively, were available. On April 15, 1982, Rule 146 was superseded by Rule 506²⁰ of the Regulation D exemptions. Rules 147 and 506 provide non-exclusive safe harbors, compliance with which will result in sections 3(a)(11) and 4(2), respectively, being deemed available. Because these rules are non-exclusive, an issuer need not choose between compliance with either rule and its statutory counterpart.²¹ The broader statutory exemption may be a fall back for attempted compliance with the safe harbor. In addition to Rule 506, Regulation D includes two additional safe harbors for certain other small offerings.²² Each of

19. 17 C.F.R. § 230.147 (1985).

20. 17 C.F.R. § 230.506 (1985), 47 Fed. Reg. 11251 (Mar. 16, 1982).

21. See introductions to 17 C.F.R. §§ 230.147, 230.501 (1985).

22. SEC Rules 504 and 505, 17 C.F.R. §§ 230.504-505 (1985).

the Regulation D safe harbors has a common definitional section with additional general provisions.

Rule 147. Rule 147 attempts to narrow uncertainties under Section 3(a)(11) by defining elements such as "person resident," "doing business within," "single issue," and "limitation on resales." Rule 147 does provide greater certainty of application than section 3(a)(11). Conditions of Rule 147 include:

- (1) that the issuer is a resident (as defined) and doing business (as defined) in the state in which the securities are offered and sold;
- (2) that all offerees and purchasers (other than specified foreign purchasers) are residents within such state; and
- (3) that the issuer take precautions against interstate distribution, including limiting resales for a period of nine months after the last sale which is a part of the issue.

Inadvertent or immaterial deviations from the Rule 147 requirements will cause the exemption to be lost. An offer made to a corporation, the principal office of which is outside the state, can remove the availability of the exemption. Similarly, the failure to put a particular legend on certificates, even if no resales occur within the specified period, may cause the exemption to be lost. These risks in attempting compliance with the safe harbor may lead the start-up company to conclude that the best course is to comply as best as possible with the Rule, but depend on section 3(a)(11), even with its uncertainties. Because the private offering exemption may also be potentially available, a shotgun approach to compliance may be the most effective approach. This will allow the start-up to rely on the potential availability of each of the exemptive provisions.

Regulation D. Whether by default or by devise, most offerings by start-up companies depend upon Rule 4(2) and Regulation D. Much has been written concerning Regulation D in the three years since it was implemented, and several fine summaries of its provisions exist.²³ The SEC in its release adopting Regulation D stated that the Regulation was "designed to simplify existing rules and regulations, to eliminate any unnecessary restrictions that those rules and regulations place on issuers, particularly small businesses,

23. E.g., Donahue, *New Exemptions From the Registration Requirements of the Securities Act of 1933: Regulation D*, 10 SEC. REG. L.J. 235 (1982); Donahue, *Regulation D: A Primer for the Practitioner*, 8 DEL. J. CORP. L. REV. 495 (1983); Schneider, *Introduction to Regulation D*, 15 REV. SEC. REG. 990 (1982); Schneider, *Regulation D—Evaluation and Critique* (part 2) 15 REV. SEC. REG. 983 (1982).

and to achieve uniformity between state and federal exemptions in order to facilitate capital formation consistent with the protection of investors."²⁴

Rule 506 relates to transactions which are deemed to be exempt from registration under section 4(2) of the 1933 Act. Rule 506 is available to all issuers for offerings sold to not more than 35 sophisticated purchasers, plus an unlimited number of "accredited investors."²⁵ Rule 506 requires the issuer to make a subjective determination that each purchaser, other than accredited investors, meets certain sophistication standards, but does not require, as the predecessor to Rule 146 did, that each offeree meet sophistication standards. The exemption retains the concept of a "purchaser representative" so that unsophisticated purchasers may participate with the aid of another person. There is no requirement under Rule 506 that an investor be able to bear the economic risk of investment. Rule 506 prohibits any general solicitation or general advertising and mandates that certain disclosure be made.

Rule 505 provides an exemption for offers and sales not exceeding \$5,000,000 in any 12 month period where sales are made to not more than 35 purchasers and an unlimited number of accredited investors. Rule 505 is available to corporations, partnerships, and any other issuer that is not an investment company. No general solicitation or advertising may be employed. Rule 505 does not impose sophistication requirements for purchasers of securities as does Rule 506. Certain information is required to be disclosed, varying on whether or not the issuer is a reporting company under the 1934 Act.

Availability of the Rule 504 exemption is limited to situations where no more than \$500,000 of securities is to be sold in a 12 month period. The advantage of Rule 504 is that there is no ceiling

24. SEC Release No. 33-6389 (Mar. 8, 1982), 24 SEC DOCKET 1166. In SEC Release No. 34-6437 (Nov. 19, 1982), 26 SEC DOCKET 1090, a new preliminary note 7 was added (relating to sales to non-United States residents and citizens), the Note to Rule 502(a) was modified, Rule 502(a) was modified, and Rules 502(b)(2)(i)(C) and (D) were added.

25. Accredited investor under Rule 501 of Regulation D means any person who comes within one of the following eight categories or who the issuer *reasonably believes* comes within one of the categories at the time of sale: (1) certain identified institutional investors such as banks, insurance companies and registered investment companies; (2) private business development companies; (3) organizations exempt from taxes under § 501(c)(3) of the Internal Revenue Code; (4) directors, executive officers or general partners of the issuer; (5) any person who purchases \$150,000 of securities where the purchase price does not exceed 20% of the purchaser's net worth; (6) individuals with a net worth exceeding \$1,000,000; (7) individuals with \$200,000 in income anticipated for the current year; and (8) entities composed entirely of accredited investors. Reg. D, 17 C.F.R. § 230.501 (1985).

on the number of investors, and if the offering is conducted exclusively in states where it is qualified or registered with the state securities commission (and if the state requires the delivery of disclosure documents before sale), there are no restrictions on the manner of the offering and on resale.

Rules 501 through 503 provide certain definitions and general conditions applicable to all Regulation D offerings. The eight terms defined in Rule 501 are (i) "accredited investor," (ii) "affiliate," (iii) "aggregate offering price," (iv) "business combination," (v) "calculation of number of purchasers," (vi) "executive officer," (vii) "issuer," and (viii) "purchaser representative."

Despite the improved certainty under Regulation D, the availability of the Rule 505 and 506 exemptions hinges on some critical subjective determinations, including:

- (1) whether the issuer has taken sufficient steps to have a "reasonable belief" as to purchaser qualification;
- (2) whether the issuer reasonably believes that the purchaser representative meets the Regulation D requirements;
- (3) whether non-accredited investors are involved, and if so whether adequate information has been provided; and
- (4) whether inadvertent failure to meet a technical requirement (such as the date of filing or purchasers representative acknowledgment) will cause the exemption to be unavailable despite the issuer's best efforts.

Of the above factors, the information requirement is the most difficult for a start-up business to meet, especially in high technology fields with which investors are not generally familiar. Therefore, the attorney will often be faced with clients wishing to spend the least money possible to meet these standards, which ordinarily means omitting as much disclosure as possible. If sales are made only to accredited investors, Rule 505 and 506 do not require specific disclosures other than restrictions on transferability.²⁶ When sales are made to as few as one unaccredited investor, however, there are specific information requirements which vary depending on the size of the offering and nature of the issuer.²⁷ Start-up com-

26. SEC Release No. 33-6455, § II.A (Mar. 3, 1983), 27 SEC DOCKET 347, 354.

27. This article focuses on disclosures required by companies without securities registered under the Securities Exchange Act of 1934 and which are raising less than \$5,000,000. The requirements for all issuers are found in Rule 502(b) of Regulation D. Generally, all other issuers are subject to slightly greater disclosure requirements.

Note that this differential in disclosure is a recognition by the SEC of a cost/benefit analysis in disclosure similar to the cost/benefit decision with respect to Regulation D. Indeed the entire thrust of the liberalization of the small offering provisions has been a trade off

panies making offerings of up to \$5 million must provide the same *kind* of information required by Part I of Form S-18 or, for issuers to whom Form S-18 is not available, the information required is that specified by the applicable registration form that would be used in a public offering.

The information required to be provided under Regulation D need not be included in one document,²⁸ or be received at the time of the offer. However, it is normal to have some sort of written disclosure document that investors can review prior to the closing of their investment. Even when no disclosure document is required by Regulation D, it is recognized as good legal protection from the antifraud provisions under Sections 12(2) and 17(a) of the 1933 Act²⁹ and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934,³⁰ to provide a private placement memorandum.

To understand how potentially burdensome the information requirements necessary to meet these safe harbor standards can be, it is useful to review the specific kinds of information specified in Form S-18. Several primary areas raise disclosure compliance issues for start-up companies. Good legal counsel in these areas can separate the important from the unimportant, so that scarce resources can be best allocated to preparing the most important disclosures.

The disclosures required in connection with sales of securities to unaccredited investors tie directly into the standard disclosure items for public offerings registered with the SEC in Regulation S-K.³¹ The applicable items of Regulation S-K cited in Form S-18 include disclosures concerning use of proceeds, business operations, properties, legal proceedings, selected financial data, management information and remuneration, transactions with management and certain parties, risk factors and interests of named experts and counsel. In addition, the following financial statements are required to be certified by an independent certified public accountant unless to obtain such statements would require "unreasonable effort and expense":

- a. audited balance sheet as of the end of the most recent fiscal

of costs to the issuer versus protection to the investor. This is a different cost/benefit analysis from that of the issuer. Reg. D, 17 C.F.R. § 230.502(b) (1985).

28. SEC Release No. 33-6455 § II.A. (Mar. 3, 1983), 27 SEC DOCKET 347, 354, Question and Answer No. 40. [The answer states that several disclosures are adequate provided material information is not obscured in the process.]

29. 15 U.S.C. § 771(2) (1983); 15 U.S.C. § 77q(a) (1983).

30. See 15 U.S.C. § 78 (1983), 17 C.F.R. § 240.10b-5 (1985).

31. 17 C.F.R. § 229 (1985).

- year, or as of a date within 135 days of the date of their memorandum if the issuer has been operating for less than one year;
- b. an interim balance sheet (unaudited) within 135 days of the date of the memorandum if the audited balance sheet is dated prior to such date; and
- c. audited statements of income, changes in financial position, and stockholder's equity for the two prior fiscal years and for any interim period.

A literal application of these disclosure requirements would mean great expense to an issuer. However, the SEC staff in informal settings has placed a heavy emphasis on the general qualifier that appears in Rule 502(b)(2)(i) relating to non-reporting companies. That rule requires disclosure "to the extent material to an understanding of the issuer, its business, and the securities being offered."³² Moreover, Regulation D only requires that the information include "the same kind of information" required by Form S-18. The net effect of these provisions is to throw any offering to nonaccredited investors into a subjective playground of materiality. Compliance is a question of judgment dependent on the experience and capability of the securities lawyer. The attorney has few guidelines to which to refer the client. If a client is raising a substantial sum of money and has sufficient funds, it can choose to be very safe or, if so inclined, it can cut corners on the theory that investors are receiving all material information. Financial information can be further restricted with the justification that its preparation would entail unreasonable effort and expense.

Although issuers in many cases begin an offering with the intent of approaching only accredited investors, very often the offering cannot be successfully completed on this basis. Notwithstanding the additional risk, the offering is often broadened in order to have a chance of success. Such expansion does not leave sufficient time for qualified counsel to consider the materiality of each particular disclosure in order to prepare an adequate disclosure document. For this reason, many disclosure documents are not sufficient to meet the strict Regulation D disclosure standards. The attorney should not let this occur without determining where the client will next look for an exemption and explaining the risk that the new exemption may not be available.

An attorney should counsel that some effort should be made to comply fully, within reason, with the information requirements of Form S-18 unless it is abundantly clear that specified information is

32. 17 C.F.R. § 230.502(b)(2)(i) (1985).

immaterial. However, the client should be made aware of the extent of uncertainty in legal requirements and the considerable potential savings. The continuum of the range of compliance must be explained. Together with the client, the attorney can construct a course of action that allows the transaction to proceed, given limited financial resources, yet provides the best legal protection to the client. Even within the greater certainty of Regulation D, a cost/benefit approach is a necessity to choose the most appropriate course.

Some of the principal areas in which counsel may provide the client with assistance in balancing the Regulation D disclosure requirements are set forth below. These are often the areas in which a high technology start-up business runs a high risk of non-compliance.

1. *Description of the Business*

Item 101(c) of Regulation S-K sets forth the disclosure requirements for "Narrative Description of the Business," including 12 specific items.³³ Securities counsel familiar with the SEC knows that finalizing the business description can involve significant give and take with underwriters, underwriters' counsel, accountants and the SEC staff. Such prolonged drafting in the context of a registration leads to a document that can be comfortably assumed to comply with the Item. However, for the early-stage business, that disclosure process is an unobtainable luxury. Of course, if all *material* information is included there is no risk connected with non-compliance. Unfortunately, what is material is always viewed in hindsight—often a loss has occurred and an investor is suing for the investor's money back. Moreover, for a high technology business, getting the description into layman's language and put forward in a concise and readable manner is difficult. This may be especially true when there are no industry prospectuses or offering circulars

33. Item 101 of Regulation S-K sets forth the registration statement disclosures required for filings with the SEC on Form S-1. Item 101(c) calls for a narrative description of the company's business. The discussion must be broken down with separate discussions of each of the company's industry segments. The item requires a discussion of the principal products produced and services rendered by the company and the markets for and distribution of them, the status of any material product in development and the sources and availability of raw materials. The item also requires disclosure of the importance and duration of patents, trademarks and other such rights, the seasonality of the business, industry practices with respect to working capital, the company's dependence on a small number of customers and the amount of firm backlog. Three year's worth of research and development expenditures and the competitive conditions in the industry also must be disclosed. Reg. S-K, 17 C.F.R. § 229.101 (1985).

for comparison. The role of good counsel is to identify the material items that add value or bring risk to the business so that the client can expend resources effectively to describe these items. Even if the client does not wish to incur the expense of having counsel draft the description, the attorney should discuss areas of particular exposure so that the client can complete the disclosures.

2. *Backlog and Principal Customers*

Regulation S-K specifically requires that the firm backlog of the company be reported and that principal customers (greater than 10%) be identified. In the private offering context there is often little if any backlog. Many companies are sensitive to disclosures such as these, but they are material and are not good areas in which to cut corners in disclosure.

3. *Management, Compensation and Certain Transactions*

The requirements in Rules 301, 302 and 303 of Regulation S-K for management and related party transactions can be complex.³⁴ This is an area in which it is common to cut corners in a private placement memorandum. Often, compensation information which would not be unusual if disclosed is, nevertheless, sensitive within the company itself. Related party transactions may be omitted because the founder feels they were fair and are not material to investors. Although good arguments can be made that such omissions are justified, care should be exercised that "qualitative materiality" (items that reflect on the quality or integrity of management) is discussed with the client. Often, transactions of no financial interest reflect on the quality of management and are clearly material from a securities standpoint.

4. *Use of Proceeds*

Too often, private placement memoranda use boilerplate "use of proceeds" sections that are very general. Early stage companies often have very specific financial needs and targeted uses. The section discussing use of proceeds must tie to the plan of business described in the memorandum. Counsel involvement in these areas, if written disclosure is prepared, is always cost-effective.

34. See Harroch, *The Private Placement Memorandum—Management and Ownership Interest*, START-UP COMPANIES, § 10.07 (1985).

5. *Risk Factors*

Early stage businesses that do not include a carefully tailored and specific risk factor written disclosure document to investors waste their best insurance policy.³⁵ The risk factors should always relate to discussion elsewhere in the memorandum that provide more detail. Quite often, this section can use more attention than it is given, and, unfortunately, omissions are usually material. Time and effort spent on this section should always be cost-effective if disclosure is prepared.

6. *Projections*

The SEC encourages issuers to include projections of future economic performance when filing securities.³⁶ Rule 175³⁷ under the 1933 Act and Rule 3b-6³⁸ under the Securities Exchange Act of 1934 provide safe harbors to protect certain forward looking statements in SEC filings. The safe harbors protect forward looking statements made in good faith and with a reasonable basis. There is no similar safe harbor for projections in private placement memoranda. However, the SEC has indicated in a no-action letter that projections in a private offering memorandum are acceptable if made under the standards of the safe harbor, presented in an appropriate format and accompanied by information adequate to allow the investors to make their own judgments.³⁹ The entrepreneur may believe projections are important to sell his or her securities. Often projections are stretched so that a reasonable basis is not apparent and sufficient backup is not included. Although a client may decide it is not cost-effective to have an attorney or accountant review projections, the risk of inclusion should be made clear by the attorney.

7. *Exhibits and Opinions*

The exhibits that are normally filed with the SEC in connection with registration statements do not need to be included in a private placement memorandum to meet the disclosure requirements of Regulation D. However, they need to be listed and made available to investors upon request. This includes a required opinion of coun-

35. *Id.*

36. See General Note (b), Regulation S-K, 17 C.F.R. § 229 (1985).

37. 17 C.F.R. § 230.175 (1985).

38. See generally, 17 C.F.R. § 240.3b-6 (1985).

39. SEC No Action Letter, Reg. A, 3(b)-Rule 254, Hendricks & Tomlinson, Avail. July 15, 1976.

sel if tax attributes are important to investors (as in research and development partnerships). Issuers may imperil their exemption if they decide not to provide such information. The issuer should be advised that the decision that it is not worth the expense to prepare these items may be a decision to depend on an exemption outside of the safe harbors.

III. LONG TERM VERSUS SHORT TERM COST

The preceding discussion has argued that a cost/benefit approach to securities law compliance is not only possible, but for the start-up company may be appropriate because in many areas a broad range of compliance exists. Assessment of the risk an issuer and its founders are willing to bear is an important determinant of the ultimate decision. However, the appropriate cost/benefit trade-off does not merely involve assessing whether one will be discovered to be in violation of the securities laws and, if so, the short-term financial consequences. It is also not a matter merely of the likelihood of success in a civil lawsuit.

Entrepreneurs, assisted by counsel, should review the long-term needs and desires of the company and its shareholders and act consistently with those goals. Without a perspective on the decision, early-stage companies can focus exclusively on short-term considerations. Thus, if without a capital infusion, the company will close its doors and stop research on its only future product, the company may wish to assume more extreme risk through a very liberal approach to compliance. A real estate partnership that will self-liquidate and conduct no other offerings of securities and which has a conservative investment objective may have no need to consider future securities issuances or the negative publicity associated with securities litigation. Similarly, early-stage companies may allocate legal resources initially to one area, such as trade secret or patent protection. It may be a valid business decision that such expenditures are more important than money spent on securities compliance.

Most entrepreneurs connected with high-technology start-ups seek to build a successful enterprise and then capitalize on their success through a sale of the company or taking the company public. In addition to these goals, however, these entrepreneurs commonly desire to maintain acceptance in their communities and retain options for future business opportunities. These ultimate goals are a benefit that should be worth substantial costs, both in terms of personal effort and legal and other professional fees. Knowledge of

these goals, and experience in compliance, can help obtain the benefits of compliance at the lowest ascertainable cost.

Good counsel in securities compliance, in this light, can be money well spent. The client need not take the most conservative path, and is not well served by an attorney capable only of seeing a transaction in this light. On the other hand, a cavalier approach to securities law compliance or retention of counsel unfamiliar with the issues, in order to minimize short-term costs, can be equally damaging. Securities counsel familiar with the ultimate goal can tailor the degree of compliance. If a company desires to make an eventual public offering of its stock, it will require clean legal opinions to the underwriters of the offering. Securities counsel can help avoid contingent liabilities that may hinder or prevent future sales of the company's securities.

Non-securities issues have adverse securities implications in the event of a subsequent public or private offering of securities. Loose contract practices or credit extensions can lead to contingent obligations or expensive legal negotiations prior to a documented public offering. Similarly, overly complex compensation arrangements adopted without benefit of counsel may be embarrassing to include in a subsequent SEC disclosure document. In each case, a short-term decision that the cost of compliance, or proper documentation, exceeded short-term needs, may run counter to the long-term corporate interests. In each case the decision as to the allocation of corporate resources is still properly a business decision; however, good counsel can accommodate the process.

The taint that may accompany even the appearance of a securities law problem is often the most important consideration to individuals involved in a start-up company. A civil action, and surrounding publicity, may adversely affect a company even when the company ultimately prevails. Similarly, because disclosure may be required in subsequent offerings, it can hinder capital raising by individuals or the company in the future, or increase the cost of raising such funds. If an administrative enforcement action is brought successfully (which includes a settlement to avoid litigation costs), individuals may be prevented by state laws or Rule 505 from access to the private offering exemptions.⁴⁰ None of these factors

40. Rule 505(b)(2)(iii) removes the availability of the Rule 505 exemption from issuers described in § 230.252(c), (d), (e), or (f) of Regulation A, with certain exemptions. 17 C.F.R. § 230.505 (1985). Generally, these provisions make the exemption unavailable if the issuer, any of its predecessors or affiliates, or any of its officers, directors, general partners or owners of 10% or more of any class or security have been convicted within 10 years of a felony or misdemeanor in connection with the purchase or sale of any security, or are subject to an

should prevent an intelligent cost/benefit approach to an issue, but all of them demonstrate the necessity for good and knowledgeable counsel to make the proper decision. In addition, with good counsel, risks can be minimized by allocating scarce company resources to the most crucial compliance areas.

IV. CONCLUSION

The uncertainty of legal standards under securities laws encourages intelligent cost/benefit decisions by businesses. This article has outlined how strict technical compliance in the private offerings of securities may be practically impossible for many small companies. A realistic appraisal of the risks involved in proceeding with compliance is critical. To the extent that our legal training views these issues in a right/wrong vacuum, lawyers run the risk of doing a disservice to their clients. Appropriate legal counsel should differentiate the clearly legal from the clearly illegal, but should not downplay the judgments involved in distinguishing these extremes. Assuming a client is operating in good faith, this course should not cause counsel significant ethical problems. Of course, no attorney is compelled to continue representing a client whose judgment is suspect in the counsel's eyes, and counsel should not knowingly assist in avoiding clear legal requirements. But the decision of liberal versus conservative approach to securities compliance is ultimately a business decision to be made by the client with advice from experienced counsel.

order, judgment or decree of a court enjoining or restraining any continuing practice in connection with the sale of any security. Many states have adopted similar prohibitions which remove the availability of private offering exemptions under state law.

